

Durham Research Online

Deposited in DRO:

22 January 2019

Version of attached file:

Accepted Version

Peer-review status of attached file:

Peer-reviewed

Citation for published item:

Tilba, Anna and Reisberg, Arad (2019) 'Fiduciary duty under the microscope : stewardship and the spectrum of pension fund engagement.', *Modern law review.*, 82 (3). 456–487.

Further information on publisher's website:

<https://doi.org/10.1111/1468-2230.12413>

Publisher's copyright statement:

This is the accepted version of the following article: Tilba, Anna Reisberg, Arad (2019). Fiduciary Duty under the Microscope: Stewardship and the spectrum of Pension Fund Engagement. *Modern Law Review* 82(3): 456-487, which has been published in final form at <https://doi.org/10.1111/1468-2230.12413>. This article may be used for non-commercial purposes in accordance With Wiley Terms and Conditions for self-archiving.

Additional information:

Use policy

The full-text may be used and/or reproduced, and given to third parties in any format or medium, without prior permission or charge, for personal research or study, educational, or not-for-profit purposes provided that:

- a full bibliographic reference is made to the original source
- a [link](#) is made to the metadata record in DRO
- the full-text is not changed in any way

The full-text must not be sold in any format or medium without the formal permission of the copyright holders.

Please consult the [full DRO policy](#) for further details.

Fiduciary Duty under the Microscope: Stewardship and the Spectrum of Pension Fund Engagement

By: Anna Tilba and Arad Reisberg*

ABSTRACT

This study examines how UK pension fund trustees interpret the concept of their fiduciary duties in practice and how these interpretations may shape pension fund approaches to corporate stewardship and engagement as envisioned by the UK Stewardship Code. Using the data from 35 in-depth, semi-structured interviews with pension fund trustees, executives, investment intermediaries and a series of round-table discussions with pensions experts, the study uncovers interpretive pluralism of the concept of Fiduciary Duty in the area of pension funds. A model identifying the spectrum of pension fund engagement is developed, showing how different interpretations of fiduciary duty may be linked to various intensity and methods of engagement in practice. The findings help disambiguate the concept of ‘fiduciary duty’, highlighting the challenges of Stewardship Code application in practice. These insights are very relevant to the ongoing revisions of the Stewardship Code and further policy clarifications of the nature of fiduciary duty by the UK Financial Conduct Authority. This paper encourages trustees, regulators and others to consider closely what role pension fund trustees *should* have in stewardship, which may not be directly relevant to their fiduciary duties as trustees.

Key words: Fiduciary Duty; Institutional Investor; Pension Fund Ownership; Investor Stewardship; Kay Report

Draft: December 2018. Please do not copy without author’s permission

* Corresponding Author, Dr. Anna Tilba, Associate Professor in Strategy and Governance, Durham University Business School, Mill Hill Lane, Durham, DH1 3LB, Tel: +44 (0)191 3349428 email: anna.tilba@durham.ac.uk

The authors wish to thank the Editor, Prof. Andrew Lang and the Reviewers for their helpful comments and feedback. We also wish to thank the following colleagues for their comments on earlier drafts of this paper: Luca Enriques, Dionysia Katelouzou, Jonathan Rushworth, Edward Walker-Arnott and Con Keating. Special thanks go to Deborah Sabalot for her legal expertise in financial services, regulatory and compliance issues, particularly in relation to trustee fiduciary duties and for her in-depth and constructive comments and feedback on the crucial final revision of this article.

INTRODUCTION

Institutional investors¹ are said to be pivotal to two vital dimensions of modern capital markets, firstly for the value of public corporations they own, and secondly, for the financial security of savers who invest through them. Regulators count on institutional investors to help police the market against the risk of either repeat systemic crimes and fraud or CEO pay rising. Yet, in the wake of the Financial Crisis of 2007-2008 institutional investors were repeatedly blamed for being part of the problem that led to the market crash. In particular, their passivity, lax engagement and disinterest in exercising proper oversight of their investee companies were heavily criticized.² In the aftermath of the crisis and the governance reviews that followed³, the concept of a 'Fiduciary Duty' was hastily (and perhaps inappropriately) put forward as a legal and practical platform that could guide the development of institutional investor practices,

¹ The Code defines "institutional investors" as asset owners and asset managers with equity holdings in UK listed companies. Asset owners are defined in the Code to include pension funds, insurance companies, investment trusts and other collective investment vehicles. As the providers of capital, asset owners set the tone for stewardship and may influence behavioural changes that lead to better stewardship by asset managers and companies. Asset managers as defined as those with day-to-day responsibility for managing investments on behalf of the asset owners and are in a position to influence companies' long-term performance through stewardship. Page 2, Para. 2 and Page 1, Para. 6.

² A Reisberg, 'The UK stewardship code: On the road to nowhere?' (2015) 2 Journal of Corporate Law Studies, 217.

³ For the overview of the development of the Stewardship Code see B. Cheffins, 'The Stewardship Code's Achilles' Heel' (2010) 73 Modern Law Review 1004, and Reisberg, 'The UK stewardship code: On the road to nowhere?' (2015) 2 Journal of Corporate Law Studies, 217.

particularly those relating to extending the stewardship role vis-a-vis investee firms⁴. The success of this approach was dependent to a great extent on the large number of investors such as asset managers, insurance companies and pension funds to be actively engaged with the companies. From this perspective, the diligent exercise of shareholder stewardship⁵ became essential to reinforce the ‘comply or explain’ effects of the UK Corporate Governance Code⁶.

Although no longer the largest group of investors in the UK market, pension funds⁷ are considered both by scholars and policymakers to be particularly significant for stewardship because of their ‘patient capital’, which is designed (in theory) to

⁴ J. Hawley, A. Hoepner, K. Johnson, J. Sandberg, and E. Waitzer ‘Cambridge Handbook of Institutional Investment and Fiduciary Duty’ (2014) Cambridge University Press; Financial Reporting Council, The Stewardship Code, (2012) [https://www.frc.org.uk/getattachment/d67933f9-ca38-4233-b603-3d24b2f62c5f/UK-Stewardship-Code-\(September-2012\).pdf](https://www.frc.org.uk/getattachment/d67933f9-ca38-4233-b603-3d24b2f62c5f/UK-Stewardship-Code-(September-2012).pdf) (last visited 15 April 2018), London; J Kay, The Kay Review of UK Equity Markets and Long-Term Decision Making (July 2012).

⁵ The Code defines “stewardship” as “For the investor, stewardship aims to promote the long-term success of companies in such a way that the ultimate providers of capital also prosper. For investors, stewardship is more than just voting. Activities may include monitoring and engaging with companies on matters such as strategy, performance, risk, capital structure, and corporate governance, including culture and remuneration. Engagement is purposeful dialogue with companies on these matters as well as on issues that are the immediate subject of votes at general meetings.” Code, Page 1, Para. 4.

⁶ Reisberg, , 'The UK stewardship code: On the road to nowhere?' (2015) 2 Journal of Corporate Law Studies, 217.

⁷ Davies indicates that the beneficial share ownership of UK equities by pension funds has steadily been decreasing from the peak of 31.7% in 1993 to only 4.7% in 2012. P. Davies, ‘Shareholders in the United Kingdom’ (2015) ECGI Working Paper Series in Law 27.

generate returns for their beneficiaries over the longer term.⁸ However, a host of barriers seem to prevent all but a handful of funds⁹ from meeting the expectations placed on them as ‘owners’ of public corporations. Alongside the more obvious barriers such as dispersed share ownership and the associated problems of co-ordination, management and control; free-rider problems,¹⁰ other problems of diversification; rational apathy and informational deficit¹¹ have been pointed out. The long chain of intermediaries from

⁸ L. Ryan and M. Schneider, ‘The Antecedents of Institutional Investor Activism’ (2002) 27 *Academy of Management* 4, 554-573; S. Davis, J. Lukomnik and D. Pitt-Watson, ‘The New Capitalists: How Citizen Investors are Reshaping the Corporate Agenda’ (2006) Boston, Mass.: Harvard Business School Press; R. Martin, P. Casson and T. Nisar, ‘Investor Engagement: Investors and Management Practice Under Shareholder Value’ (2007) Oxford University Press; Financial Reporting Council, *The Kay Review* (2012). *The Kay Review of UK Equity Markets and Long-Term Decision Making*. [available at: <http://www.bis.gov.uk/assets/biscore/business-law/docs/k/12-631-kay-review-of-equity-markets-interim-report.pdf>]

⁹ It should be noted here that, if constituted as a trust the pension fund is not a separate legal person but only acts through its trustees.

¹⁰ Martin, P. Casson and T. Nisar, ‘Investor Engagement: Investors and Management Practice Under Shareholder Value’ (2007) Oxford University Press; A. Schäfer and U. von Arx, ‘The Influence of Pension Funds on Corporate Governance’ (2014) 46 *Applied Economics* 19, 2316.

¹¹ Reisberg, A, ‘The UK stewardship code: On the road to nowhere?’ (2015) 2 *Journal of Corporate Law Studies*, 232.

ultimate beneficial interests through to the investee company also represent a significant barrier to engagement.^{12 13}

In the context of the FRC's ongoing review of the UK Corporate Governance Code¹⁴ and the Stewardship Code (2012)¹⁵, it seems that the commitment to these general principles seems to be much easier to achieve at a theoretical level than in practice. Various commentators and regulators have asked why shareholders have not exercised more control over investee companies. Lord Myners (then the Financial

¹² J Rhee, 'Short-Termism of Institutional Investors and the Double Agency Problem' (9 May 2013)

HLS Forum on Corporate Governance and Financial Regulation

<https://corpgov.law.harvard.edu/2013/05/09/short-termism-of-institutional-investors-and-the-double-agency-problem/> [last visited 17 January 2019]; A. Tilba and T. McNulty, 'Engaged versus Disengaged Ownership: The Case of Pension Funds in the UK' (2013) 21 Corporate Governance: An International Review 21(2):165-182.

¹³ A. Tilba and J. Wilson, 'Vocabularies of Motive and Temporal Perspectives: Examples of Pension Fund Engagement and Disengagement' (2017) British Journal of Management, 11.

¹⁴ FRC, (December, 2017) Proposed Revisions to the UK Corporate Governance Code at:

<https://frc.org.uk/getattachment/f7366d6f-aa57-4134-a409-1362d220445b/./.aspx> [last visited 12 March, 2018].

¹⁵ FRC, The Annual Review of Corporate Governance and Reporting 2017/2018 (October 2018)

<https://www.frc.org.uk/getattachment/f70e56b9-7daf-4248-a1ae-a46bad67c85e/Annual-Review-of-CG-R-241018.pdf> [last visited: November 12, 2018].

The UK Stewardship Code (2012) [https://www.frc.org.uk/getattachment/d67933f9-ca38-4233-b603-3d24b2f62c5f/UK-Stewardship-Code-\(September-2012\).pdf](https://www.frc.org.uk/getattachment/d67933f9-ca38-4233-b603-3d24b2f62c5f/UK-Stewardship-Code-(September-2012).pdf) [last visited 30 April 2017].

Services Secretary to the Treasury) described institutional investors as “absentee landlords” and stated that institutional investor inactivity had contributed to what he termed the “ownerless corporation.”¹⁶ An OECD Report (February 2011)¹⁷ on the contributing causes of the global financial crisis concluded that institutional investors were generally not effective in monitoring investee companies. At present, companies like BHS, Carillion, which has 13 pension schemes, GKN (with the hostile takeover bid by Melrose) British Steel/Tata, and Toys R Us, lead to questions being asked about the monitoring role of the pension trustees and the Pensions Regulator, particularly in light of increasing pension deficits and yet continuous dividend payments to shareholders.

A number of scholars have begun to question the effectiveness of the UK Stewardship Code itself arguing that it lacks the capacity to achieve its goals.¹⁸ Active pension fund trustees’ involvement in corporate governance thus appears more assumed than demonstrated, while the motivations behind these contrasting approaches to equity ownership necessitate further investigation. Despite reforms and continuous

¹⁶ Lord Myners, ‘Association of Investment Companies’(April 2009), at:

http://webarchive.nationalarchives.gov.uk/20091207163737/http://hmtreasury.gov.uk/speech_fsst_210409.htm [last visited 7 April 2018].

¹⁷ OECD (2011), The Role of Institutional Investors in Promoting Good Corporate Governance, Corporate Governance, page 9.

¹⁸ B. Cheffins, ‘The Stewardship Code's Achilles' Heel’ (2010) 73 Modern Law Review 1004; D.

Arsalidou, ‘Institutional Investors, behavioural economics and the concept of Stewardship’ (2012) 6

Law and Financial Market Review 6, 410; Reisberg. A, 'The UK stewardship code: On the road to

nowhere?’ (2015) 2 Journal of Corporate Law Studies; Tilba. A. and Wilson, J.F. (2017). Vocabularies

of Motive and Temporal Perspectives: Examples of Pension Fund Engagement and Disengagement.

British Journal of Management, 28(3), 1-17, p. 13.

development of best practices in *corporate* governance, little attention has been placed specifically on the governance of pension schemes. While good pension scheme governance is, indeed, essential, there is a necessary precursor, that the purpose of the scheme and the responsibilities of the trustees be well-defined and understood. However, there are still serious omissions in these debates, which this study aims to help address.

Furthermore, pension fund trustees are legally bound by common law fiduciary duty, which requires trustees to proceed with prudence and to act in the best interests of the beneficiaries. Notwithstanding recently heightened attention and expectations placed on fiduciary duties, our understanding of how this central concept shapes pension fund trustees'¹⁹ approaches to investment is still lacking in clarity both in academic research and practice²⁰. The lack of clarification around 'fiduciary duties' continues to be a topic of significant interest to the policy makers as evident from the ongoing Financial Conduct Authority's discussion paper on the Duty of Care and potential

¹⁹ It should be noted that in English law, a trust is not a separate legal entity from the personalities of its trustees.

²⁰ J. Sandberg, '(Re-)Interpreting Fiduciary Duty to Justify Socially Responsible Investment for Pension Funds. (2013) 21 Corporate Governance: An International Review, 436; UK Law Commission, 2014 Fiduciary Duties of Investment Intermediaries http://www.lawcom.gov.uk/app/uploads/2015/03/lc350_fiduciary_duties.pdf [last visited 15 April 2018]; J. Hawley, A. Hoepner, K. Johnson, J. Sandberg, and E. Waitzer 'Cambridge Handbook of Institutional Investment and Fiduciary Duty' (2014) Cambridge University Press.

alternative approaches²¹. To my knowledge, no studies have yet empirically investigated how pension fund trustees interpret and apply the concept of fiduciary duties in their investment practices and how it shapes their approach to stewardship and engagement.

This study contributes to the scarce literature on pension fund governance and shareholder engagement in several respects. Theoretically, this paper answers calls to disambiguate the concept of ‘fiduciary duty’²² by developing a model, which identifies a range of interpretations of fiduciary duty and relating them to specific forms and methods of pension fund stewardship and corporate engagement. This article reveals varying degrees of pension fund engagement and financial focus. Four distinct interpretations and approaches are emerging: Disengagement, Employer Engagement, Fund Manager Engagement and Corporate Engagement.

These empirical findings suggest that trustees have different understandings of their role and of the purpose of a pension fund. The findings reveal the interconnection of the legal responsibilities and how trustees interpret these responsibilities and

²¹ Financial Conduct Authority (2018) Discussion paper on the duty of care and potential alternative approaches <https://www.fca.org.uk/publication/discussion/dp-18-05.pdf> [last visited on 30 October 2018].

²² J. Sandberg, ‘(Re-)Interpreting Fiduciary Duty to Justify Socially Responsible Investment for Pension Funds. (2013) 21 Corporate Governance: An International Review, 436; UK Law Commission, 2014 Fiduciary Duties of Investment Intermediaries http://www.lawcom.gov.uk/app/uploads/2015/03/lc350_fiduciary_duties.pdf [last visited 15 April 2018]; J. Hawley, A. Hoepner, K. Johnson, J. Sandberg, and E. Waitzer ‘Cambridge Handbook of Institutional Investment and Fiduciary Duty’ (2014) Cambridge University Press.

stewardship and engagement. More specifically, there is a distinct tension between trustees' stewardship responsibilities and the exclusive focus on financial performance within pension funds, where stewardship seems to pull trustees in a different direction from what they consider to be the purpose of a pension fund (i.e. focusing on generating financial returns and securing retirement income, not fixing corporate governance problems). Ultimately, this paper contributes to the ongoing policy debates concerning investor stewardship and fiduciary duties within the investment chain by revealing challenges of using the concept of fiduciary duty as a tool of corporate governance. In so doing, the findings raise questions about the levels of pension fund compliance with the Stewardship Code in the spirit that it was originally intended.

The paper is structured as follows: it begins with a brief introduction of the UK Stewardship Code, highlighting some of the challenges of institutional compliance with the Code. Focusing on pension funds, this study looks at the trustee's fiduciary duties as an essential but little explored concept which is closely linked to pension fund compliance with the Stewardship Code. The paper then draws on the qualitative data and develops a spectrum of pension fund engagement, which outlines different forms and methods of pension fund engagement, linking them to trustees' interpretations of their fiduciary duties. This model exposes not only variations in pension fund ownership behaviour, but also explains why such variations may exist. The Discussion elaborates on the contribution of this study to current corporate governance debates on the nature of fiduciary duty and institutional investor engagement. Policy Implications highlight the challenges of Stewardship Code application in the pension fund context and offer further clarifications on 'fiduciary duty' and how it can be applied in practice in relation to the Stewardship Code.

THE UK STEWARDSHIP CODE

The UK has long been seen as an international leader in the development of successful non-statutory and voluntary guidance and codes of best practice relating to corporate affairs.²³ Practitioners and policymakers have been placing greater emphasis particularly on institutional investors to be more active in corporate governance. In the US this is evident from The Conference Board reports,²⁴ whilst in the UK the recent financial crisis served to heighten the expectations of policy-makers that institutional investors should be acting as stewards and engaged owners of shares.²² In February 2009 Sir David Walker was commissioned to review the governance of banks and related entities²⁵. This review highlighted that:

‘while institutional investors could not have prevented the [financial] crisis, ...with hindsight it seems clear that...board and director shortcomings...would have been tackled more effectively had there been

²³ For the historic overview of the development of these codes see B. Cheffins, ‘The Stewardship Code’s Achilles’ Heel’ (2010) 73 Modern Law Review 1004; and A. Tilba, (2016) Evolution of UK Corporate Ownership and Control: Governance, Complexity and Context. In: JF Wilson, JFS. Toms; A de Jong, E. Buchnea, ed. The Routledge Companion to Business (2017) History, Abington, Oxon: Routledge, 300.

²⁴ e.g. M. Tonello, ‘Revisiting Stock Market Short-Termism’ (2006) The Conference Board Report No. R-1386-06-RR. The Conference Board is a non-partisan, global, independent business membership and research association working in the public interest. See <https://www.conference-board.org/about/index.cfm?id=1980> [last visited 24 April 2018].

²⁵ D. Walker, A Review of Corporate Governance in UK Banks and Other Financial Industry Entities: Final Recommendations (HM Treasury 2009), 71-72, at https://webarchive.nationalarchives.gov.uk/+/www.hm-treasury.gov.uk/d/walker_review_261109.pdf [last visited 7 April 2018].

*more vigorous scrutiny and engagement by major investors acting as owners*²⁶

By 2010 this pro-intervention perspective was embodied in the semi-official UK Stewardship Code, which consisted of seven principles very similar to the Institutional Shareholders' Committee and was informally enforced on the 'comply or explain' basis. In the same spirit, the report by Professor John Kay²⁷ in 2012 has been highly critical of the way UK equity markets have been geared towards generating short-term investment profits. Prof. Kay emphasized the need for a shift towards long-term and fiduciary standards²⁸, necessitating loyalty and prudence within the investment world. Part of the financial services industry seems to have committed itself to do better as there were over 1600 signatories with more than EUR 60 trillion in assets under management as of December 2016 to the United Nations sponsored Principles for

²⁶ [last visited 7 April 2018].

²⁷ John Kay, The Kay Review of UK Equity Markets and Long-Term Decision Making. Final Report, July, 2012
https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/253454/bis-12-917-kay-review-of-equity-markets-final-report.pdf [last visited 18 October 2018].

²⁸ Kay set out as one of his Principles the applicable fiduciary standard as follows: "All participants in the equity investment chain should observe fiduciary standards in their relationships with their clients and customers. Fiduciary standards require that the client's interests are put first, that conflict of interest should be avoided, and that the direct and indirect costs of services provided should be reasonable and disclosed. These standards should not require, nor even permit, the agent to depart from generally prevailing standards of decent behaviour. Contractual terms should not claim to override these standards." Ibid. p. 65.

Responsible Investment.²⁹ Similarly, the directive of non-financial reporting by the European Union encouraged institutional investors to be active owners, which means incorporating environmental, social and governance (ESG) issues within their investment strategies and practices.³⁰

Thus, institutional investor engagement and activism has become a desirable activity in public policy terms.³¹ However, commitment to these general principles seems to be much easier to achieve at a theoretical or strategic level than in daily operations and practices as there seems to be a variety of definitions of what

²⁹ United Nations Principles for Responsible Investment (UN PRI), 2016. Signatories to the Principles for Responsible Investment. <https://www.unpri.org/signatories> [10 December 2017] (last visited 15 April 2018).

³⁰ European Union (EU). Directive 2014/95/EU of the European Parliament and of the Council of Information by Certain Large Undertakings and Groups. <http://eur-lex.europa.eu/legalcontent/en/TXT/?uri=CELEX%3A32014L0095> [10 December 2017] (last visited 15 April 2018); European Union (EU). 2014b. Proposal for a Directive of the European Parliament and of the Council Amending Directive 2007/36/EC as Regards the Encouragement of Long-Term Shareholder Engagement and Directive 2013/34/EU as Regards Certain Elements of the Corporate Governance Statement, COM/2014/0213 final – 2014/0121 (COD). <http://eur-lex.europa.eu/legalcontent/EN/TXT/?uri=COM%3Ab2014%3A213%3AFIN> [10 December 2017] (last visited 15 April 2018). October 2014 Amending Directive 2013/34/EU as Regards Disclosure of Non-financial and Diversity <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32014L0095> [last visited: 15 April 2018].

³¹ Davies, P. (2015). Shareholders in the United Kingdom. ECGI Working Paper Series in Law, nr. 280/2015, 18.

‘Stewardship’ really means.³² The 2012 Stewardship Code was promoted at European Union level by the European Commission³³ but it contained no definition of stewardship and so it was vague as to whether the Code was confined to securing good corporate governance in investee companies or extended to intervention to secure changes in managerial policy.

The distinctive elements of stewardship behaviour involve a ‘shared sense of ongoing responsibility to multiple stakeholders, which affects a focus on collective welfare over the long term.’³⁴ In the context of institutional investors, ‘stewardship’ is used as to encourage the long-term success of companies by protecting and enhancing the value of the firm to the ultimate benefit of an investor (Stewardship Code, 2012).

The EU Corporate Governance Framework, Green Paper³⁵ suggests that *“Shareholder engagement is generally understood as actively monitoring companies, engaging in a dialogue with the company’s board, and using shareholder rights, including voting and cooperation with other shareholders, if need be to improve the*

³² Reisberg, A, ‘The UK stewardship code: On the road to nowhere?’ (2015) 2 Journal of Corporate Law Studies, 228.

³³ Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee of the Regions Action Plan: European company law and corporate governance - a modern legal framework for more engaged shareholders and sustainable companies /* COM/2012/0740 final */ , Para. 2.4 <https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:52012DC0740> [last visited: 16 April 2018].

³⁴ Hernandez, M. (2012). Toward an Understanding of the Psychology of Stewardship. Academy of Management Review, 37(2), 176.

³⁵ Green Paper (2011) The EU corporate governance framework /* COM(2011) 164 final <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A52011DC0164> [last visited 7 April 2018].

governance of the investee company in the interests of long-term value creation.”³⁶ The 2009 Walker Review of corporate governance in banks and financial companies suggests that “the term ‘engagement’ relates to procedures designed to ensure that shareholders derive value from their holdings by dealing effectively with concerns about under-performance.”³⁷ This includes: arrangements for monitoring investee companies; arrangements for meeting as appropriate with a company’s chairman or senior management; a strategy for intervention where judged appropriate, and policy on voting and voting disclosure. The UK Law Commission report on Fiduciary Duties of Investment Intermediaries in 2014 defines stewardship activities as including the monitoring of and engaging with companies on matters such as strategy, performance, risk, capital structure and corporate governance, including culture and remuneration.³⁸ All in all, the development of these ‘soft’ codes and increasing expectations on investors to become involved in corporate governance has consequently assumed certain benchmarks of success or failure to ‘comply or explain’.

³⁶ (April, 2011), para. 2.1.

³⁷ D. Walker (2009), A Review of Corporate Governance in UK Banks and Other Financial Industry Entities: Final Recommendations (HM Treasury 2009), 71-72
https://webarchive.nationalarchives.gov.uk/+/www.hm-treasury.gov.uk/d/walker_review_261109.pdf , para 5, 14 [last visited: 17 January 2019].

³⁸ UK Law Commission (2014) Fiduciary Duties of Investment Intermediaries
http://www.lawcom.gov.uk/app/uploads/2015/03/lc350_fiduciary_duties.pdf , xiv. [last visited: 15 April 2018].

Historically, through equity ownership, pension funds represented an important class of institutional investors who were potentially in a position to play a significant role in the evolution of UK ownership.³⁹ Subsequently, academics and policy makers showed great interest in pension fund engagement activities and their outcomes within corporate governance literature. However, whether stewardship can bear the weight placed upon it is not yet clear as there is a mixed empirical research of both engagement and disengagement by institutional investors.⁴⁰ Most recent academic reviews of the current state of shareholder activism literature suggest that the research on shareholder engagement (both financial and social) offers conflicting perspectives on this topic, calling for more research into more relational and behavioural aspects of investor activities to explain investor 'exit' or voice'.⁴¹

The low level of shareholder activism in the UK is notable, which raises questions of the strength of the incentives for UK shareholders to coordinate and exercise their shareholder powers, particularly directly intervening in company

³⁹ J. Franks, C. Mayer, and S. Rossi, 'Ownership: Evolution and Regulation' (2005) Social Science Research Network, 4009; Davies, P. (2015). Shareholders in the United Kingdom. ECGI Working Paper Series in Law, nr. 280/2015, 2.

⁴⁰ For a review of recent literature about pension fund engagement and disengagement see Tilba. A. and Wilson, J.F. (2017). Vocabularies of Motive and Temporal Perspectives: Examples of Pension Fund Engagement and Disengagement. *British Journal of Management*, 28(3), 2-3.

⁴¹ M. Goranova and L. Ryan, 'Shareholder Activism: A Multidisciplinary Review' (2014) 40 *Journal of Management*, 5, 1230-1268; T. McNulty and D. Nordberg, 'Ownership, Activism and Engagement: Institutional Investors as Active Owners' (2016) 24 *Corporate Governance: An International Review* 3, 335.

management, even in the presence of a shareholder-friendly set of governance rules.⁴² Schäfer and von Arx note that such disengagement can be explained by the largely dispersed share ownership of pension funds and free rider problems.⁴³ Tilba, et. al. also found that the vast majority of UK pension funds are disengaged owners who focus primarily on investment return generation at the expense of corporate governance considerations.⁴⁴

The existing empirical studies cast doubt on the applicability of the Stewardship Code. Moreover, a number of academics have begun to articulate concerns about the ability of the Code to encourage 'engaged ownership' by institutional investors. For example, Cheffins argues that it is unlikely that the Stewardship Code will be able to foster substantially greater shareholder involvement in UK corporate governance due to sustained fragmentation of share ownership occurring over recent decades.⁴⁵ Arsalidou argues that behavioural economics casts doubts on the capacity of institutional investors to act rationally and in accordance with these ideas, challenging

⁴² Davies, P. (2015). Shareholders in the United Kingdom. ECGI Working Paper Series in Law, nr. 280/2015, 2.

⁴³ A. Schäfer and U. von Arx, 'The Influence of Pension Funds on Corporate Governance' (2014) 46 *Applied Economics* 19, 2316.

⁴⁴ Tilba, A and McNulty, T. (2013). Engaged versus Disengaged Ownership: The Case of Pension Funds in the UK. *Corporate Governance: An International Review*, 21, p. Tilba. A. and Wilson, J.F. (2017). Vocabularies of Motive and Temporal Perspectives: Examples of Pension Fund Engagement and Disengagement. *British Journal of Management*, 28(3), 7.

⁴⁵ B. Cheffins, 'The Stewardship Code's Achilles' Heel' (2010) 73 *Modern Law Review*, 1004.

the assumption that the Code will succeed.⁴⁶ Reisberg goes further and suggests that the Stewardship Code is '*trivial, absent of meaning and incapable of achieving its goals*'⁴⁷ because pension fund trustees demonstrate a kind of rational (or irrational) reticence when it comes to stewardship and engagement.

Clearly, limited research on pension fund governance focuses on the types of pension fund engagement activities as variables, relating them to specific outcomes at the expense of shedding light on the motivations that underpin such behaviour. Therefore, it is now crucial to have a broader awareness of trustees' understanding of a purpose of a pension scheme and their duties in relation to that trust.

PENSION FUND GOVERNANCE AND ORGANISATIONAL ETHOS

There are only a few studies that identify weaknesses and flaws in the pension funds' own governance and accountability mechanisms, as a contributory factor in the investor's failure to exercise the desired shareowner stewardship. For example, the lack

⁴⁶ D. Arsalidou, 'Institutional Investors, behavioural economics and the concept of Stewardship' (2012) 6 Law and Financial Market Review 6, 415.

⁴⁷ Reisberg, 'The UK stewardship code: On the road to nowhere?' (2015) 2 Journal of Corporate Law Studies, 217 and 241.

of investment expertise on trustee boards⁴⁸, pension fund size⁴⁹, and the influence of strong-willed and/or more experienced board members or the CEOs of the corporate sponsor who may prioritise the interests of the corporate sponsor above all else.⁵⁰ These studies, however, provide limited explanations of what motivates shareholder behaviour. For example, Aguilera, et. al. find that some institutional investors in the UK have significantly increased the level of involvement with their investee companies, putting forward instrumental (self-driven), relational (group-oriented and legitimising) and moral (appropriate behaviour) motives exemplifying the Corporate Social Reasonability (CSR) activities of the UK's Universities Superannuation Scheme

⁴⁸ Myners Report (2001). *Institutional Investment in the United Kingdom: A Review*. London: HM Treasury, United Kingdom; G.Clark, E. Carlewy-Smith, and J. Marshall, 'The Consistency of UK Pension Fund Trustee Decision-Making' (2007) 6 *Journal of Pension Economic and Finance* 1,

67; G. Clark, and R. Urwin, 'Leadership, Collective Decision-Making, and Pension Fund Governance'

(2008) available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1133015 [last visited 15

April 2018)]. Tilba, A and McNulty, T. (2013). Engaged versus Disengaged Ownership: The Case of Pension Funds in the UK. *Corporate Governance: An International Review*, 21, 173-174.

⁴⁹ T. Noe, 'Investor Activism and Financial Market Structure' (2002) 15 *Review of Financial Studies* 1,

289; R. Dharwadkar, M. Goranova, P. Brandes, and R. Khan, 'Institutional Ownership and

Monitoring Effectiveness: It's Not Just How Much but What Else You Own' (2008) 19 *Organization*

Science 3, 419.

⁵⁰ J. Cocco, and P. Volpin, 'Corporate Governance of Pension Plans: the U.K. evidence' (2007) 63

Financial Analysts Journal 1, 70.

(USS).⁵¹ Lindenberg and Steg also distinguish between altruistic, biospheric (i.e. environmental and societal) values and egotistic values, which can influence pro-social behaviour within organisation.⁵²

An important conclusion of Hendry, et al. is that institutional investors see themselves not as active ‘owners’, but primarily as financial ‘traders’ who happen to control key resources as a result of their trading and whose interests are divorced from those of long-term share ownership.⁵³ Similarly, Bengtsson draws links between institutional values and investment behaviour by highlighting that the involvement of institutional investors in corporate governance is not only influenced by law and regulation, but also by moral and societal obligations, as well as relational ties, which seem to be attached to the overall ‘*ethos*’ or a purpose of an organisation.⁵⁴ More recently, Ormiston, et. al. suggest that investor’s expectations regarding risk, return and impact vary according to their organisational intentions, noting that ‘financial first’ investors tend to include banks, pension funds, wealth funds and finance institutions that seek market-

⁵¹ R. Aguilera, C. Williams, J. Conley, and D. Rupp, ‘Corporate Governance and Social Responsibility: a comparative analysis of the UK and the US’ (2006) 14 Corporate Governance: An International Review 3, 147.

⁵² S. Lindenberg and L. Steg, ‘Normative, gain and hedonic goal frames guiding environmental behaviour’ (2007) 63 Journal of Social Issues 117.

⁵³ J. Hendry, P. Sanderson, R. Barker, and J. Roberts ‘Responsible Ownership, Shareholder Value and the New Shareholder Activism’ (2007) 11 Competition and Change 3, 223.

⁵⁴ E. Bengtsson, ‘Organizational approaches to corporate governance: an empirical study on shareholder activism’ (2007) 3 International Journal of Business Governance and Ethics 3, 238.

competitive financial returns on their investments.⁵⁵ Organisational *ethos* can be defined as –‘the distinguishing character, sentiment, moral nature or guiding beliefs of a person, group or institution’⁵⁶. Ethos may represent organisational values such as sustainability, growth or customer focus, which can, in turn, either fit or clash with wider values associated with, for example, the political beliefs or personal values of the people who work outside and inside organisation, be it executives, board directors, academics, or the policy-makers within the wider arena that an organisation operates in. The values of stakeholders (for example, current and future retirees of pension fund and the owners, employees and sponsors) can influence the values and ethos of the pension fund through governance.⁵⁷

In the UK pension funds, organisational ethos is associated with the overall purpose to provide retirement benefits to its members at costs acceptable to the employer⁵⁸. Trustees’ duties in relation to the fund are to act prudently, honestly and in the best interest of the members.⁵⁹ However, the literature

⁵⁵ J. Ormiston, K. Charlton, S. Donald, and R. Seymour, ‘Overcoming the Challenges of Impact Investing: Insights from Leading Investors’ (2015) 6 Journal of Social Entrepreneurship 3, 352.

⁵⁶ Merriam Webster’s Collegiate Dictionary, 1994.

⁵⁷ R. Sievänen, R. Hannu, and B. Scholters, ‘European Pension Funds and Sustainable Development: Trade-Offs between Finance and Responsibility’ (2017) 26 Business Strategy and the Environment 914.

⁵⁸ It should be noted that this is not a “one size fits” all situation as some large pension funds have “professional”/corporate trustees while other smaller DB funds have worker/employee trustees who clearly have less awareness of the role and responsibilities of the trustee.

⁵⁹ The Pensions Regulator (2010). The Trustee Toolkit, available at: <http://www.thepensionsregulator.gov.uk/trustees.aspx> [last visited 15 April 2018].

about engaged and disengaged behaviour of pensions funds suggests that some pension fund trustees may understand differently what is the ultimate purpose of the trust and that may shape their subsequent approach to stewardship and engagement with portfolio firms. For example, in a most recent quantitative study into European Pension funds trade-offs between finance and responsibility Siavänen, et. al. find that there is a difference in organisational values that pension funds exhibit.⁶⁰ The authors relate altruistic values to the pension fund responsibility which means that a pension fund considers ESG issues as well as good governance practices. In contrast, an appreciation of financial performance is related to egotistic values.

In the context of the UK, Tilba and Wilson provide evidence to suggest that engagement or disengagement of pension funds may be a *product* of trustee rhetoric, often constructed in unnoticed ways through the choice of internal and external, often irrational, explanations and justifications of their behaviour.⁶¹ What remains unclear is what organisational ethos is associated with pension funds' approach to engaging with corporations. Questions about the nature of the pensions' trustee's duties and obligations come to the fore.

PENSION FUNDS AND FIDUCIARY DUTY

⁶⁰ Siavänen, R., Hannu, R. and Scholters, B. (2017). European Pension Funds and Sustainable Development: Trade-Offs between Finance and Responsibility. *Business Strategy and the Environment*, 26, 922.

⁶¹ Tilba, A. and Wilson, J.F. (2017). Vocabularies of Motive and Temporal Perspectives: Examples of Pension Fund Engagement and Disengagement. *British Journal of Management*, 28(3), 12-13.

Pension fund trustees owe certain legal duties to their members, which is currently interpreted as a greater stewardship role towards the firms in which they are invested⁶². However, is it unclear if this normative prescription holds any promise for a change in investment behaviour towards stewardship because as a concept ‘fiduciary duty’ is highly flexible, loose and uncertain. Sandberg suggests that it seems to be understood and enacted by practitioners in a variety of ways.⁶³ The uncertainty associated with fiduciary duty is also evident from the on-going reviews of the roles of financial intermediaries in relation to ESG meaning only below for the first time issues conducted by Freshfields Bruckhaus Deringer,⁶⁴ the United Nations Environment

⁶² The Kay Review (2012). The Kay Review of UK Equity Markets and Long-Term Decision Making. <http://www.bis.gov.uk/assets/biscore/business-law/docs/k/12-631-kay-review-of-equity-markets-interim-report.pdf> 65. [last visited 15 April 2018].

⁶³ Sandberg, J. (2013). (Re-)Interpreting Fiduciary Duty to Justify Socially Responsible Investment for Pension Funds. *Corporate Governance: An International Review* 21(5), 436.

⁶⁴ Known as the Freshfields Report, Freshfields Bruckhaus Deringer A legal Framework for the Integration of Environmental, Social and Governance Issues into Institutional Investment. Report produced for UNEP FI (2005) available at: <http://uksif.org/wp-content/uploads/2012/12/FRESHFIELDSBRUCKHAUS-DERINGER-2005.-A-legal-framework-for-the-integration-of-the-EnvironmentalSocial-and-Governance-issues-into-institutional-investment-UKSIF-Summa.pdf> [last visited 15 April 2018].

Programme Finance Initiative,⁶⁵ and the Law Commission.⁶⁶ There is a case to be made that the explanation of differences in approach to equity ownership, stewardship and engagement lies in the different meanings and interpretations that pension fund trustees assign to their fiduciary duties.

The best starting point in explaining these duties is to look at pension legislation and the trust deed. Firstly, it is important to note that the verb ‘fiduciary’ means ‘to trust’.⁶⁷ Indeed, UK pension funds originate from a trust tradition which dates back over 800 years. Under trust law pension fund trustees are required to manage the assets for the beneficiaries of the trust who could not adequately do so themselves⁶⁸. In other words, the trust is designed to protect ‘the interests of the vulnerable’, with others

⁶⁵ UNEP FI, 2009, UNEP Finance Initiative Innovative Financing for Sustainability available at http://www.unepfi.org/fileadmin/documents/unepfi_overview_2009.pdf [last visited 15 April 2018].

⁶⁶ The Law Commission (2013) Fiduciary Duties of Investment Intermediaries: Initial Questions at: <https://www.lawcom.gov.uk/project/fiduciary-duties-of-investment-intermediaries/> [last visited, 7 April 2018].

⁶⁷ Sandberg, J. (2013). (Re-)Interpreting Fiduciary Duty to Justify Socially Responsible Investment for Pension Funds. *Corporate Governance: An International Review* 21(5), 437.

⁶⁸We note here, that one can argue that some beneficiaries have more financial acumen than the trustees. Trust law doesn’t really address the disparity (if it exists) between the superior knowledge of the trustees and the relatively vulnerable beneficiaries although this may, in fact, be the case. We keep this in mind when ascribing this principle to protecting “the interests of the vulnerable”.

having discretionary power to act on their behalf.⁶⁹ Thus, fiduciary duty requires ‘the duty of loyalty’ and ‘the duty of care’, with trustees given a central role in ensuring their observance.⁷⁰

The Duty of Loyalty

The duty of loyalty is at the core of fiduciary responsibilities, based on the assumption that trustees must act in the sole best interests of beneficiaries. This means acting in good faith, avoiding conflicts of interest and not deriving personal profit from the exercise of fiduciary responsibilities.⁷¹ However, it is unclear what these ‘best interests’ are or should be for pension funds,⁷² as opposed to directors of a company who, it is clear, should exercise their powers ‘bona fide in what they consider – not what a court may consider – is in the best interests of the company,’⁷³ and not for any collateral

⁶⁹ The Law Commission (2013) *Fiduciary Duties of Investment Intermediaries: Initial Questions* at: <https://www.lawcom.gov.uk/project/fiduciary-duties-of-investment-intermediaries/> [last visited, 7 April 2018], 5-6.

⁷⁰ *Ibid*, page 5-6.

⁷¹ Fair Pensions, (2011) *The Enlightened Shareholder - Clarifying Investors’ Fiduciary Duties* available at: <https://shareaction.org/wp-content/uploads/2016/01/EnlightenedShareholderReport.pdf> [last visited 15 April 2018].

⁷² The Law Commission, (2013), *Fiduciary Duties of Investment Intermediaries: Initial Questions* at: <https://www.lawcom.gov.uk/project/fiduciary-duties-of-investment-intermediaries/> [last visited, 7 April 2018] 15.

⁷³ The ‘company’ in this context is not usually construed as meaning the company as a detached legal entity and the courts look for some humans by which to gauge it. Thus in *Gaiman v Association for*

purpose.’⁷⁴ Similarly, in *Dorchester Finance v Stebbing*,⁷⁵ Foster J stated: ‘A director must exercise any power vested in him as such, honestly, in good faith and in the interests of the company’. In the case of a pension scheme, the task seems not to be straightforward: trustees must use their investment powers to earn returns to provide a pension. This is best demonstrated by quoting The Pensions Regulator, which states that trustees must ensure that pension fund investments deliver value for money and good investment outcomes. Accordingly, the interpretation of ‘best interests’ often assumes investing in the best *financial* interests of members.⁷⁶ The focus on ‘financial’ best interest suggests that such interpretations of the fiduciary duty may preclude

Mental Health [1971] Ch 317, 330 Megarry J said, ‘I would accept the interests of both present and future members of the company as a whole, as being a helpful expression of a human equivalent. See now the duty to promote the success of the company enshrined in section 172 of the Companies Act, 2006.

⁷⁴ [1942] Ch 304, 306.

⁷⁵ [1989] BCLC 498.

⁷⁶ Sandberg, (2013) above n 17, 437. Furthermore in a recent tweet, Alastair Hudson highlights that:

‘The starting point is the duty of trustees to exercise their powers in the best interests of the present and future beneficiaries of the trust. The duty of the trustees towards their beneficiaries is paramount’.

Megarry J, *Cowan v Scargill*, a case on a pension fund the best interests of the beneficiaries are normally their best financial interests”. In financial regulation, “best interests” is a positive duty on professionals: they must achieve them. The best financial interests of USS members are a Defined Benefit scheme. This principle is the legal sun around which all other pensions law moons revolve. The trustee must look to the best interests of the members. That does not entitle them to prioritise employers’ wishes over members’ best interests’ (@ProfAlastair, 7 April 2018).

trustees from considering long-term and non-financial factors, a conclusion that demands an empirical investigation⁷⁷.

The Duty of Care

Although fiduciary duty is legally a different concept from the ‘duty of care’⁷⁸, in fulfilling fiduciary duty, UK pension fund trustees are required to act prudently,

⁷⁷ B. Richardson, ‘From Fiduciary Duties to Fiduciary Relationships for Socially Responsible Investing: Responding to the Will of Beneficiaries’ (2011) 1 *Journal of Sustainable Finance and Investment* 1, 5; Sandberg, (2013), above n 17, 444-445; The Law Commission, above n 62, 5

⁷⁸ Fiduciary duty is legally a different concept to a “duty of care”. Article 1 of the Trustee Act 2000 provides: The duty of care.

(1) Whenever the duty under this subsection applies to a trustee, he must exercise such care and skill as is reasonable in the circumstances, having regard in particular—(a) to any special knowledge or experience that he has or holds himself out as having, and (b) if he acts as trustee in the course of a business or profession, to any special knowledge or experience that it is reasonable to expect of a person acting in the course of that kind of business or profession.

(2) In this Act the duty under subsection (1) is called “the duty of care”.

Schedule 1 of the Act sets out the basis on which this “duty of care” applies to trustees:

SCHEDULE 1

Application of duty of care

Investment

1 The duty of care applies to a trustee—

(a) when exercising the general power of investment or any other power of investment, however conferred; (b) when carrying out a duty to which he is subject under section 4 or 5 (duties relating to the exercise of a power of investment or to the review of investments).

Agents, nominees and custodians

3(1) The duty of care applies to a trustee—(a) when entering into arrangements under which a person is authorised under section 11 to exercise functions as an agent; (b) when entering into arrangements under

namely, to exercise the care, diligence and skill that a prudent person of business would exercise in managing his or her own affairs. This is sometimes referred to as the ‘prudent man rule’⁷⁹, which typically implies that trustees should seek advice when they make investment decisions if they are not investment experts⁸⁰. In short, the duty of care guards against carelessness and incompetence⁸¹. The concept of care and ‘prudence’ came to be interpreted in terms of having a sensible investment strategy for

which a person is appointed under section 16 to act as a nominee;(c)when entering into arrangements under which a person is appointed under section 17 or 18 to act as a custodian; (d)when entering into arrangements under which, under any other power, however conferred, a person is authorised to exercise functions as an agent or is appointed to act as a nominee or custodian; (e)when carrying out his duties under section 22 (review of agent, nominee or custodian, etc.).

(2)For the purposes of sub-paragraph (1), entering into arrangements under which a person is authorised to exercise functions or is appointed to act as a nominee or custodian includes, in particular—(a) selecting the person who is to act,(b)determining any terms on which he is to act, and (c)if the person is being authorised to exercise asset management functions, the preparation of a policy statement under section 15.

⁷⁹ The Law Commission, (2013), *Fiduciary Duties of Investment Intermediaries: Initial Questions* at: <https://www.lawcom.gov.uk/project/fiduciary-duties-of-investment-intermediaries/> (last visited, 7 April 2018), 53.

⁸⁰ Sandberg, J. (2013). (Re-)Interpreting Fiduciary Duty to Justify Socially Responsible Investment for Pension Funds. *Corporate Governance: An International Review* 21(5), 438.

⁸¹ The Law Commission, (2013), *Fiduciary Duties of Investment Intermediaries: Initial Questions* at: <https://www.lawcom.gov.uk/project/fiduciary-duties-of-investment-intermediaries/> (last visited, 7 April 2018), 5

the asset portfolio, emphasizing wealth creation through diversification, rather than wealth preservation⁸².

Another interpretation of the duty of care seems to extend beyond the financial growth of the fund to encompass wider environmental, societal and governance (ESG) issues. This rationale is underpinned by an assumption that if the purpose of a pension trust is to provide pensions, then the purpose of a pension fund is to provide a decent standard of living for the retired members through considerations of the non-financial factors within the investment strategy.⁸³

Whether the duty of care is compatible with purposefully taking into account ESG issues has been the subject of intense debate, particularly in the context of some high-profile and large institutional investors such as the California Public Employees' Retirement System (CalPERS) and the New York Teachers Retirement System in the US, as well as the Universities Superannuation Scheme (USS) in the UK. These bodies are taking a lead role in the Socially Responsible Investment and corporate engagement movement, on the basis that these activities are compatible with their fiduciary duty as

⁸² Fair Pensions, (2011), The Enlightened Shareholder - Clarifying Investors' Fiduciary Duties

[available at:

http://shareaction.org/sites/default/files/uploaded_files/policy/EnlightenedFiduciaryReport.pdf], 18

[last visited 17 April 2018].

⁸³ Fair Pensions, (2011), The Enlightened Shareholder - Clarifying Investors' Fiduciary Duties

http://shareaction.org/sites/default/files/uploaded_files/policy/EnlightenedFiduciaryReport.pdf 13 [last visited 7 April 2018].

trustees⁸⁴. What remains unclear, however, is whether any of these suggestions are plausible for other pension funds. Theoretically and practically we are thus left with a question of what is the nature of fiduciary obligation, how it is understood and discharged in practice; and what do these observations suggest about the nature and a purpose of a pension fund.⁸⁵

Using the data collected as part of a bigger study⁸⁶ into pension fund investment practices the following section elaborates on the empirical findings from 35 in-depth, semi-structured interviews with pension fund trustee, executives, investment intermediaries and a series of round table discussions with pensions experts. These initial 35 interviews with pension fund trustees, executives, investment intermediaries were complemented by a series of meetings and round-table discussions which took place in London as part of the Law Commission Consultation on Fiduciary Duties of Investment Intermediaries to which one of the authors⁸⁷ has contributed. The discussions with pensions, legal, investment and policy experts, aimed at establishing which factors pension fund trustees consider, or should consider, when investing assets

⁸⁴ Sandberg, J. (2011). Socially Responsible Investment and Fiduciary Duty: Putting the Freshfields Report into Perspective. *Journal of Business Ethics* 101, 143-162.

⁸⁵ The Law Commission, (2013), *Fiduciary Duties of Investment Intermediaries: Initial Questions at:* <https://www.lawcom.gov.uk/project/fiduciary-duties-of-investment-intermediaries/> [last visited, 7 April 2018], 1.

⁸⁶ Tilba, A. (2011). *Pension Fund's Investment Practice and Corporate Engagement*. PhD Thesis, University of Liverpool Management School, 126; Tilba, A. and McNulty, T. (2013) '*Engaged versus Disengaged Ownership. The Case of Pension Funds in the UK*' *Corporate Governance: An International Review*, 21(2): 165-182.

⁸⁷ Tilba, A. shared her expertise in pension fund governance, investment management and corporate engagement as a member of the Law Commission Advisory Board for the Consultation and the Final Report on Fiduciary Duties of Investment Intermediaries (2013/2014). The Law Commission Final Report. No. 307 <https://www.lawcom.gov.uk/project/fiduciary-duties-of-investment-intermediaries/> [last visited 17 April 2018].

on behalf of members. In particular, it was vital to inquire whether they should take into account corporate governance or stewardship issues, and how far trustees take those issues on board. The discussions resulted in further analysis of the interview data for a fine-grained understanding of the interview content, particularly relating to the concept of pension fund ‘trust’ and trustee ‘fiduciary duties’ in relation to investment and stewardship.

PLURALITY OF FIDUCIARY DUTY INTERPRETATIONS

One of the key observations this study makes is that pension fund trustees interpret their fiduciary duties in a variety of ways. With particular reference to engagement, it is possible to draw parallels between their interpretations of fiduciary duties and engagement and ultimately how trustees understand the purpose of their pension fund. The findings suggest that approaches to equity ownership and stewardship are largely informed by trustees’ interpretations of fiduciary duty, resulting in the following observations.

Firstly, pension funds can be seen as positioned along an analytical spectrum of engagement, where some pension fund trustees seek to exert more influence than others over investee companies. A predominantly Disengaged approach to equity ownership is positioned at the extreme minimalistic end of the spectrum and it is associated with pension fund trustees seeing the purpose of the fund is just to pay pensions and trustees fiduciary duty of loyalty is therefore to act in the best *financial* interests of the pension fund’s members, which has nothing to do with the Stewardship Code assumptions. This approach is contrasted with Corporate Engagement at the other extreme of the spectrum. Trustees of more engaged pension funds usually interpret their obligations and the purpose of a pension fund in more broad terms, i.e. being more active in corporate

governance as stewards of invested shares. Trustees within this group interpret their duties as extending to broader environmental, social and corporate governance issues. In between the two extreme forms in the model are Corporate Employer Engagement and Fund Manager Engagement.

Within Corporate Employer Engagement, the duty of loyalty is broadly interpreted to mean acting in the best financial interests, but also meaning that the duty of care extends to considering the economic well-being of their sponsoring company, prompting engagement in the governance of their employer rather than investment portfolio companies. In the case of Fund Manager Engagement, trustees see it as their duty to maximize the investment returns, but also engage with fund managers in order to improve corporate governance of their investment portfolio for the financial benefit of pension fund members. It appears that the most meaningful strategic engagement is rare and frequently happens ‘behind closed doors’, resulting in the creation of few records.

Finally, positioning the data along the analytical spectrum of engagement suggests that most pension funds are disengaged, focusing on maximizing their investment returns. In this form, pension funds trustees do not have direct contact with investee companies, having delegated all to do with investment management and corporate engagement to investment managers.

These main findings help develop the analytical spectrum of pension fund engagement presented in Figure 1, which links different interpretations of fiduciary duties to forms and methods of engagement. This Figure can be used as a guide and a reference point to present and explain the findings, starting first with the majority of distant disengaged pension funds.

Figure 1 Stewardship, Fiduciary Duties and the Spectrum of Engagement

Insert Figure 1 about here

Disengagement

The overall pattern of pension fund behaviour towards equity investment is Disengaged. Positioned at the very minimalistic end of the spectrum, this form of equity ownership assumes that pension fund trustees delegate⁸⁸ everything linked to associated equity management to their external investment fund managers and focus fund manager mandates on investment performance. Out of thirty-five interviews undertaken for this study, twenty-two interviews suggest that the majority of pension funds *do not* have direct relationships with their investee companies, nor do they seek to influence their fund managers in any way when it comes to corporate governance or ESG issues.

Although pension fund trustees associated with this form of engagement consider corporate governance ‘*on paper*’, a director of a pension fund with nearly £4 billion of assets under management notes that there is ‘*blind delegation*’ of these responsibilities to external investment fund managers. Moreover, there appears to be very limited monitoring and no clear prescription about what engagement policy should look like and how it should be effectively communicated to fund managers. In practice,

⁸⁸ Most UK pension funds use a delegated model of investment management. It should be noted here that it doesn’t mean that only this explains their disengagement. However, we notice that more engaged funds have more in-house investment expertise so they would have a hybrid investment management model.

involvement either with the investee companies or with fund managers on the issues of corporate governance is minimal. The following statement of a current investment fund manager (also former pension fund CEO) reflects the lack of trustee interest in corporate governance and engagement:

'a lot of trustees are still probably paying lip service to the voting process and the governance process... a lot of our clients are like that...I have been to lots of pension fund trustee meetings and in nine out of ten of them trustees never ask questions about corporate governance. They are interested in our investment performance and they want to know what we are doing, what our strategy is, how we are allocating money, do we think the market is coming up or down'.

Under their operating mandate, fund managers are responsible for equity management and all that is related to corporate governance, mostly understood by pension fund interviewees as doing due diligence, research and monitoring, selecting appropriate shares if publication is in the UK and voting at company meetings. In this arrangement, the fund managers have the flexibility to decide what shares to buy and sell, how and when to vote and what methods of engagement are necessary. Engagement at this end of the spectrum is largely retrospective and relates to fund managers reporting on how they voted. The focus of the investment report relates to performance, namely, how the agreed investment benchmarks are met or outperformed. All interviews with pension funds in this cluster indicate that the fund manager mandate is oriented overwhelmingly to generating returns on investments. When the investment performance is poor, or when corporate governance concerns arise, fund managers are encouraged to exercise discipline over corporate management by selling or trading the shares (exiting), rather than engaging in corporate governance (expressing voice). In short, trustees were more

concerned with the delivery of investment performance, rather than the drivers of that performance through stewardship and engagement.

Significantly, this approach to equity ownership is informed by trustees' understanding of the purpose of the trust and what the trustees' duties are in relation to that trust. Trustees and fund executives consider that pension funds are there to provide financial security to members. A trustee's duty in relation to the trust is to ensure that pension fund assets are invested in a way to secure the financial interests of pension fund members. As a trustee of a pension fund with assets under management around £2.3 billion explains:

'We've always taken a view that we've got fiduciary duty, which is to get the appropriate level of return to meet our liabilities going forward, so we don't take account all those ESG issues, we don't screen on that basis'

The core duty of loyalty to act in the best interests of pension fund members is broadly understood by trustees as acting in the best *financial* interests, namely, the trustee's role in relation to the trust is to deliver and pay benefits when they fall due to the members of the scheme. These interpretations are evident from a majority of trustee statements about their role and duties:

'Coming back to basics, a trustee has got to act in the members' best interest – that's just a principal trust law and that's extended in the pension's law context to say that trustees have got to act in the members best financial interest... you've got to promise that the person will get his final salary on his retirement and that there is enough money there, because you promised to pay it'.

'We feel as trustees to have a duty to look after the interests of our members... and we generally try to do that by maximizing the returns relative to the risks that we take'.

Although a trustee's duty gives the trustees a fair amount of discretion in making investment decisions, provided they do it in good faith and take on appropriate investment advice, the common perception is that engagement is simply not something that trustees are supposed to be doing⁸⁹. Trustees were more interested in the sound standards of administration and other, more generic issues, such as *'being fully funded as soon as possible'* and *'getting their bloody pension.'*⁹⁰

Furthermore, spending money on engagement was also considered to be an *'unjustified'* use of pension fund resources because of the perceived lack of evidence about the *'immediate benefits'* of engagement. A CEO of an industry-wide pension fund with assets under management of £3.4 billion echoes the above statements by questioning the benefits of engagement:

'We can't necessarily demonstrate that [engagement] cost would lead to a better financial return for our members, so there is a conflict because the trustees' primary role is to look after the best

⁸⁹ See s 1 of the Trustee Act 2000 and Schedule 1 thereof.

⁹⁰ See section 3 of the Trustee Act :3 General power of investment.

(1) Subject to the provisions of this Part, a trustee may make any kind of investment that he could make if he were absolutely entitled to the assets of the trust.

(2) In this Act the power under subsection (1) is called "the general power of investment".

(3) The general power of investment does not permit a trustee to make investments in land other than in loans secured on land (but see also section 8).

(4) A person invests in a loan secured on land if he has rights under any contract under which—

(a) one person provides another with credit, and

(b) the obligation of the borrower to repay is secured on land.

(5) "Credit" includes any cash loan or other financial accommodation.

(6) "Cash" includes money in any form.

financial interests of members. How can we demonstrate that our engagement with this company has actually led to a greater financial return? Trustees can't do that, it is very difficult, they are open to challenge by members and can be successfully sued through the courts for not looking after the members best financial interests'.

It was consequently apparent from many conversations with trustees that engagement was not considered to be a prudent way of fulfilling a trustee's duty of care sensibly to grow a pension fund. Interestingly, all trustees within this sample considered that they are not qualified, or not the '*right people*', to engage with the investee companies, because the responsibility over investment choices and particular styles of management fall within the remit of an external investment fund manager. All interviewees considered their investment fund managers to be better suited to conduct engagement tasks because the fund managers '*are the ones whose performance depends on those stocks doing well, who research these companies and have an in-depth understanding of the business and when intervention is necessary*'. Therefore, delegation⁹¹ is not only a '*practical issue*', but also a way of avoiding putting liability associated with running the investment on trust. As one trustee explains:

'we are all the time cognisant of the fact that we can't do too much influencing our investment managers because if we do that [A] they can't fulfil their brief, and [B] are we actually starting to take responsibility and therefore liability back into the trustee.'

While reflecting on the role of trustees, several respondents have referred to the Pensions Act, which requires them to delegate all day-to-day investment decisions to

⁹¹ See comment on authorisation - PERG 10.3 Pension Scheme Trustees <https://www.handbook.fca.org.uk/handbook/PERG/10/3.html> [accessed 30 October 2018].

their fund managers⁹². This also includes any stewardship and engagement activities that the fund manager might carry out on behalf of trustees. This, however, is preceded by making returns on investment above all within the investment mandate.

Employer Engagement

Employer Engagement is a peculiar form of engagement because it assumes that pension funds can be both distant and involved in corporate governance. On the one hand, pension funds have very little interest in how their portfolio companies are governed, delegating investment management to external fund managers. At the same time, these schemes pay significant attention to governance of their own corporate sponsor.

The relationship with the sponsoring organisation became increasingly important as pension fund liabilities are now shown on the employer's balance sheets. The relationship between a pension fund and its employer is important, so much so that within one interview 43.3% of the entire content related to the corporate sponsor's role in pension fund investment strategy. Other interviewees have also indicated that the issues of governance of the corporate sponsor and its compliance with the codes of best practice are important to trustees. In this form of engagement, a lot of corporate governance discussions between trustees and the senior managers are routine, taking place '*behind the scenes*', involving dialogue about the overall strategic direction of the

⁹² The Pensions Regulator summarises these obligations as Duties and Powers [http://www.thepensionsregulator.gov.uk/trustees/role-trustee.aspx See also <http://www.thepensionsregulator.gov.uk/2-clear-roles.aspx> [last visited 10 April 2018].

company, rather than structural governance issues such as remuneration or the board structure.

Involvement with an employer means working towards a better and more financially secure future for the company. In turn, this means fulfilling fiduciary duty requirements by ensuring a strong and steady flow of pension contributions, which is in the interests of the pension fund members and the fund. In other words, engaging with the corporate sponsor is seen as part of a trustees' duty of care to secure employer's contributions, and in so doing to grow the fund. Disengagement with portfolio companies appears to be the enactment of the duty of loyalty to protect the financial interests of the fund members by focusing on investment performance of the investment managers, rather than the individual investee firms. As a trustee of one industry-wide pension fund with assets under management exceeding £22 billion explains:

'As a trustee, one of my first and foremost duties is to ensure that there are adequate funds to pay the benefits to the members for as long as the benefits are due to be paid. In order to achieve that you have to look at the strength of the sponsor of the company. One of the huge influences on the strength of our sponsor is the fact that we've got this guarantee of continuing business for the next 25 years.'

Interviewees explain that the reputation and the strength of the corporate sponsor, or 'employer's covenant', is key, particularly when it comes to weighing up the value of the pension promise that the employer has made to its members. A Chair of Trustees for a pension fund with assets under management exceeding £13 billion explains that she considers that her fiduciary duty is not only protecting the interests of the existing beneficiaries, but also caring for the scheme's future beneficiaries *'by keeping the scheme going forward, keeping it open for the new members and looking after tomorrow's members' interests'*, specifically by making sure that the employer remains

strong. A CEO of a UK top ten pension fund with assets under management of over £13 billion explains:

'We take our own corporate governance very seriously, the independence of the board, the process, the quality are very important...understanding the dynamics with the company ...because it is interdependent, which is the magic glue in the pension fund system between the sponsor and the trustees.'

She goes on to say that:

'Our biggest exposure is the corporate and whatever we do in any particular position, it would never have as much influence as us spending time with our corporate, making sure that we are getting the right flow of money and things are working right. It is a sensible use of time. The trustees have limited time, so you put your effort and time into things that make the biggest difference and for lots of pension schemes that are attached to the corporate, particularly in these difficult times, their attention is fundamentally going to be driven by that.... And fundamentally we still have got the financial job to do here, that's what the fiduciary responsibility is primarily, so you could not just give into something that you think is a really good cause – that's charity'.

Engagement with the employer ranged from trustees making 'petitions' in corridors, discussing corporate governance issues with the management at the trustee board meetings, persuading managers to report on their corporate actions, having telephone conversations with senior managers over issues such as dividend pay-outs, senior executive appointments, remuneration, strategy and investments, share price fluctuation, and climate change and other CSR issues. In other words, trustees were making sure that the senior managers were running the company *'in a proper manner and through the right processes that are being monitored'*. Indeed, in one case a pension fund was actually sitting in an employer's corporate governance department, which also included a legal team and senior remuneration team. In some cases trustees were even signing confidentiality agreements with the corporation not to disclose the entrusted information. Engagement was certainly not happening *'via the press'*. Interestingly,

interview questions explicitly about trustees influencing and engaging with investee companies often caused confusion because the interviewees did not see it as their duty to engage, so the answers were quite sceptical and often ironical:

‘A lot of things from the FSA (now, the FCA) or from the government implying that pension funds, as owners of assets, should be doing more and you should be influencing banks to be better in terms of managing risks. Really? Is that what we are there to do? It’s not! I don’t think it is what we are there to do. The regulator cannot expect a group of trustees who are doing their best to run a pension fund to have better knowledge than them.’

Just as with disengaged funds, the majority of respondents within this form considered themselves as not being in a position to influence ‘other’ companies because the shareholdings in individual companies were small and represented only a ‘vehicle for delivering revenues’ needed to pay out pensions to members. Interviewees indicate that although they have a ‘shareholder activism policy’ within their Statement of Investment Principles, it is mostly to ‘tick a box’ as they fully delegate to their investment fund managers and ‘almost never’ ask any questions.

Fund Manager Engagement

In the case of pension funds, this form of engagement relates not to pension funds’ activity vis-à-vis investee corporations directly, but pension funds engaging ‘one level down’ - at the fund manager level. Here, pension fund trustees can put pressure on their fund managers (through the mandate) to engage with the investee companies on a pension fund’s behalf.

While a fund manager is expected to produce returns on investment, the manager is also expected to exercise share ownership rights by voting, using either pension fund guidelines or guidelines from other industry organizations, primarily the Pension

Investment Research Consultants (PIRC)⁹³ or the Pension and Lifetime Savings Association (PLSA)^{94 95}. As shown in Figure 1, predominantly local authority pension funds are associated with this form of engagement, with eight local authorities and three occupational pension fund interviews revealing that local authority pension funds exert more pressure on their fund managers because they themselves are under public scrutiny and demand for greater transparency, particularly when it comes to disclosing voting policies.

The intensity of engagement with investment fund managers ranges from simply specifying voting guidelines to actively researching fund managers before appointment. Significant attention is spent on researching a fund manager's voting policies and corporate governance activities. The fund managers are encouraged to engage with the companies on behalf of pension funds on corporate governance issues such as: board structure; director independence; combined roles of CEO and Chairman, remuneration, senior appointments, and mergers. In short, it is primarily about due diligence.

Pension fund engagement with the investment fund managers is largely informed by how trustees and pensions' executives interpret their roles and duties. Despite the delegated nature of investment management, interviewees within this category share a common understanding that their duty in relation to the trust also includes stewardship of investee companies. Interviews indicate that in the eyes of trustees, pension funds as institutional investors should not only focus on paying out

⁹³ <http://pirc.co.uk/news-and-resources2/guidelines> [last visited 10 April 2018].

⁹⁴ <https://www.plsa.co.uk/Policy-and-Research-Stewardship> [last visited 17 April 2018].

⁹⁵ PLSA Corporate Governance Policy and Voting Guidelines 2018

pensions, but also act as responsible owners of shares by exerting influence over investee corporations through their investment fund managers. Trustees value higher standards of corporate governance as a way to safeguard against poor performance, believing that more responsible ownership would benefit the scheme's members in the long-term. A Chief Investment Officer of an occupational pension fund over £5.1 billion highlights that:

'[They] see that it is the job of the trustees to influence the managers around taking an interest in the companies and voting the shares... so we would have engagement at the manager level rather than at stock level'.

Within this form of engagement, respondents interpret their fiduciary duty of loyalty as acting in the best financial interest of the pension fund members by guarding against corporate governance failures and by pressuring investment managers to engage with portfolio firms. The interviewees also see it as the fund manager's 'job' to do so because it is the investment manager who is selecting the stocks and running the portfolio on a pension fund's behalf. A trustee from a local authority pension fund (£5 billion) explains:

'Motivation to engage with the managers was to recognise that pension funds were investing a great deal of money and shouldn't be complacent about what is going on in the underlying investments. Governance does go to value and you know if a company is being properly run according to good standards actually that should be in our best interests anyway because ultimately it should go to value'.

It is consequently apparent from discussions with trustees about their fiduciary duties that by engaging with the investment fund managers, pension fund trustees broadly fulfil their duty of loyalty to act in the best financial interests of the pension fund

members, but ‘stretching’ those interests to include non-financial interests as a means of enhancing the value of pension fund investment and the value of a pension fund.

Corporate Engagement

Within this study, only two occupational and local authority pension funds represented by the Local Authority Pension Fund Forum (LAPFF)⁹⁶ directly engaged with investee companies by conducting company research and monitoring, voting and proxy voting, writing letters, and holding face-to-face meetings with senior management and boards of directors about structural and strategic corporate governance issues. These pension funds also invested in specialist corporate governance teams in-house or worked with external industry bodies such as PIRC, RImetrics or NAPF. In discussing governance issues with senior managers, pension fund respondents gave preference to the more subtle and routine conversations *‘behind the scenes’* and *‘trying to create and maintain long-term relationships with the companies’*.

There is a difference between occupational and local authority pension funds as regards their preference for direct engagement methods. A small number of extremely large pension funds use routine negotiation and occasional outbursts of public engagement *‘to make the point’*. Local authority pension funds appear to be focusing their engagement efforts at direct management control through collaborative shareholder resolutions via the LAPFF. For example, at the time of data collection, the LAPFF sent 374 letters to investee companies expressing corporate governance concerns, as well as engaging with 316 companies on the issues ranging from executive

⁹⁶ LAPFF is a voluntary association of 48 UK public sector pension schemes that collectively promote the investment interests of local authority pension funds and maximize their influence as shareholders in promoting high standards of corporate governance and social responsibility [http://www.lapfforum.org/ last visited 17 April 2018].

remuneration to climate change. Engagement at this level is possible because through LAPFF or NAPF these funds have tens of billions of pounds of assets under management and vast internal resources. Collectively, these funds invested over £90 billion in UK equities, and in some cases the share-ownership stakes were quite substantial, providing access and enabling these funds directly to voice corporate governance concerns. Not surprisingly, these funds are atypical in the UK pension fund landscape.

Significantly, the respondents within this group of funds believe that stewardship and engagement ‘*makes sense*’ for two distinct reasons. One underlying motivation behind engagement relates to trustees interpreting their fiduciary duty as securing the best financial interests of the members where engagement adds value and produces better financial returns for the pension fund. The other relates to trustees’ personal values and a sense of altruism and responsibility, which is associated with the duty of care. This assumes being a responsible owner of shares, providing not only capital but also being concerned with environmental, social and governance (ESG) issues for the greater good of society. A more altruistic stance towards engagement is more evident in the local authority pension fund context. One of the reasons for such a ‘concentration’ of responsible investment interests within the public sector pension funds could be that local authorities are more pressured to have higher standards of public accountability and more is expected of these funds in terms of a public concern with ESG issues. These distinctions are explained in the next section.

Engagement as a Way to Maximize Investment Returns

All nine interviewees within this group of pension fund trustees justify their approach to engagement by claims that it adds value and produces better investment performance. Since better investment performance is in the best financial interests of the members,

engagement becomes part of a trustees' duty of loyalty. For example, an Executive Member of LAPFF and a trustee of a pension fund with assets under management of over £3 billion highlights that engagement:

'...adds value. It is not just altruistic...it is actually good business...there is evidence that it does add value to your shares... as much as 8% to the company value...It probably adds 20%, which is a lot'.

Notwithstanding the apparent profit-maximising motive, it may be that there are other considerations that guide trustees' decision to be involved in corporate governance, namely, trustees' personal, altruistic values that act in the best *long-term* interests of members, ensuring that the pensions' benefits could be enjoyed in future. These values seem to be arising from the broader interpretation of a trustee's duty of care, which assumes long-term growth of the fund and sustainable pensions for both existing and future members.

Engagement as a Way to Ensure a Sustainable Future

Only two occupational pension fund trustees advocated this view of equity ownership. The more altruistic stance to engagement is more evident within local authority pension funds. According to five local authority interviewees, trustees who decide to engage with the investee companies are guided by the desire to serve not just immediate pension fund members but also for the '*greater good*' of the public. A CEO of one industry-wide pension fund with assets under management of over £3 billion also notes that there are differences in the drivers of investment strategy between local authority and private sector pension funds, where public sector funds have a '*more moral view of things*' running through their investments.

Another local authority pension fund CEO (£2 billion) expressed a similar opinion:

‘We are a public sector body. In our day-to-day dealings good corporate governance, transparency with the public is key in everything we do, so we are applying that rationale to the pension fund... we have real high standards of public accountability and we just believe that that should run through our investments and if we got a chance through that investment to influence – we should be doing it’

Just by virtue of being in the public sector, local authority pension funds appear to stand out in their attempts to integrate social responsibility into their investment practice. The local authority pension fund trustees *‘feel that they have a duty’* to engage with their investee companies due to their political and ideological principles. In this case, stewardship and responsible ownership are enactments of duty of care within pension funds. In short, engagement *‘makes sense’* and is embedded in the investment philosophy and connected to the overall investment decision-making process. It is also worth noting here that such interpretations of fiduciary duty were causing tension within strategic investment decision-making because as ethical or political views were often personal, it was difficult for trustees to justify their choice of issues and embedding that within the investment strategy.

DISCUSSION

This study contributes to existing governance research in several respects. Firstly, it addresses a serious omission in corporate governance research by focusing our attention on the governance of significant and distinct types of financial institution such as pension funds. Using the lens of investor stewardship, the ultimate goal of this paper is to reveal how pension fund trustees interpret the vague concept of ‘fiduciary duty’ in their investment practices. More specifically, this paper sheds more light on whether trustees’ interpretations of their legal and regulatory duties are, indeed, compatible with investor stewardship and engagement, and thus regulators’ expectations, particularly in the context of the UK Stewardship Code. The paper also

provides more clarity around stewardship considerations and compatibility with current legal guidelines, offering views on the prospects and challenges of stewardship and engagement.

Theoretically, the paper answers calls to disambiguate the concept of ‘fiduciary duty’⁹⁷ by developing a multi-layered model which identifies a range of interpretations of fiduciary duty and relating them to specific forms and methods of pension fund stewardship and corporate engagement. Other scholars and policymakers have highlighted this ambiguity but were not able to provide empirically grounded explanations for it.⁹⁸ Four distinct approaches are revealed within this model: Disengagement, Employer Engagement, Fund Manager Engagement and Corporate Engagement. This more detailed conceptualisation of pension fund approaches to equity ownership underpinned by trustee understanding of their duties allows us to explain why some pension funds may seek to exert more influence than others over investee companies whilst others remain distant.

⁹⁷ Sandberg, J. (2011). Socially Responsible Investment and Fiduciary Duty: Putting the Freshfields Report into Perspective. *Journal of Business Ethics* 101, 143-162.

Sandberg, J. (2013). (Re-)Interpreting Fiduciary Duty to Justify Socially Responsible Investment for Pension Funds. *Corporate Governance: An International Review* 21(5), 436-446.

⁹⁸ B. Richardson, ‘From Fiduciary Duties to Fiduciary Relationships for Socially Responsible Investing: Responding to the Will of Beneficiaries’ (2011) 1 *Journal of Sustainable Finance and Investment* 1, 5; Sandberg, (2013), above n 17, 444-445; The Law Commission, above n 62, 5; Financial Conduct Authority (2018) Discussion paper on the duty of care and potential alternative approaches [<https://www.fca.org.uk/publication/discussion/dp-18-05.pdf>] (last visited on 30 October 2018).

Through the Spectrum of Engagement (Figure 1) it is possible to demonstrate how the intensity of engagement may be linked to how trustees sometimes ‘stretch’⁹⁹ the meaning of “fiduciary duty” from the very minimalistic idea of acting solely in the best financial interests (focusing on generating investment returns) to considering other factors such as the welfare of the employer/employee and other environmental, social and governance factors. These findings are particularly interesting given that few studies have examined everyday practices of pension funds and offered contrasting insights into motivations that underpin their behaviour.¹⁰⁰

This study sheds more light into this conflicting evidence on pension fund motivations¹⁰¹ and reveals that the predominant motivation of pension fund utility maximization stems from trustees’ interpretation of their duty to act in the best *financial* interests of members. This is achieved through maximizing returns on investment and focusing the investment fund managers’ mandates solely on generating investment

⁹⁹ Sandberg, (2013) above n 17, 437.

¹⁰⁰ Tilba, A and McNulty, T. (2013). Engaged versus Disengaged Ownership: The Case of Pension Funds in the UK. *Corporate Governance: An International Review* 21(2), 176-177; Tilba, A. and Wilson, J.F. (2017). Vocabularies of Motive and Temporal Perspectives: Examples of Pension Fund Engagement and Disengagement. *British Journal of Management*, 28(3), 11-13.

¹⁰¹ M. Goranova and L. Ryan, ‘Shareholder Activism: A Multidisciplinary Review’ (2014) 40 *Journal of Management*, 5, p.335; Aguilera, R.V., Williams, C.A., Conley, J.M. and Rupp, D.E. (2006). *Corporate Governance and Social responsibility: a comparative analysis of the UK and the US*. *Corporate Governance: An International Review* 14(3), 147-158; Lindenberg S, Steg L. (2007). Normative, gain and hedonic goal frames guiding environmental behaviour. *Journal of Social Issues* 63, p. 223.

performance. Ormiston, et. al. referred to this as *financial first* focus.¹⁰² In this case, the interests of a pension fund (principals) are not associated with the interests of the investee companies. The findings of this paper echo Sievänen et. al. who have observed that European pension funds who have not included stewardship in their investment strategy have a clear priority regarding their financial performance.¹⁰³

Furthermore, this study lends further support to Davies¹⁰⁴ and Hendry, et al.¹⁰⁵ who note that the majority of pension funds are not ‘real’ owners but detached quasi-owners with highly diversified portfolios. In this instance, the prevailing ideology that shareholders ‘own’ the investee company appears to be a misconception. The finding of predominantly disengaged pension funds lends further support to the academic scepticism about the effectiveness of the Stewardship Code in practice.¹⁰⁶

¹⁰² Ormiston, et. al, above n 50, 352.

¹⁰³ Sievänen, R. Hannu, and B. Scholters, ‘European Pension Funds and Sustainable Development: Trade-Offs between Finance and Responsibility’ (2017) 26 Business Strategy and the Environment 912-926.

¹⁰⁴ Davies (2015), above n 5, 18.

¹⁰⁵ Hendry, J. Sanderson, P. Barker, R. and Roberts, J. (2006). Owners or Traders? Conceptualizations of Institutional Investors and Their Relationship With Corporate Managers. *Human Relations* 59, 1101-1132; Hendry, J., Sanderson, P., Barker, R. and Roberts, J. (2007). Responsible Ownership, Shareholder Value and the New Shareholder Activism. *Competition and Change* 11(3), 223-240;

¹⁰⁶ Cheffins, B. R. (2010). The Stewardship Code’s Achilles’ Heel. *The Modern Law Review*, 73(6), 985-1025; D. Arsalidou, ‘Institutional Investors, behavioural economics and the concept of Stewardship’ (2012) 6 *Law and Financial Market Review* 6, 410; A Reisberg, ‘The UK stewardship code: On the road to nowhere?’ (2015) 2 *Journal of Corporate Law Studies*, 217.

Nevertheless, we can also see some evidence of pension fund trustees behaving like stewards in relation to shares. In the case of pension funds, the findings suggest that stewardship behaviour can be explained by the willingness and ability of trustees to ‘stretch’¹⁰⁷ the meaning of fiduciary duty, from the very minimalistic idea of acting solely in the best financial interests by generating investment returns to considering other factors such as the welfare of the employer and other environmental, social and governance issues. These funds invest similarly to what Siavänen et. al describe as altruistic pension funds responsibility,¹⁰⁸ which assumes investing also in ESG issues as well as good governance practices. This approach is broadly consistent with the interim Department of Work and Pensions (DWP) proposals to legislate stewardship activities for trustees¹⁰⁹

However, only a few occupational and predominantly local authority pension funds in the UK exhibited such an approach to equity ownership, which suggests that there may be widespread misconceptions about the nature of the obligations amongst pension fund trustees, something which is not helpful in realising the aspirations of

¹⁰⁷ It should be noted here that the language of ‘stretching’ is not intended to presuppose the ‘proper’ meaning of Fiduciary Duty.

¹⁰⁸ Siavänen, et. al. (2017) above n 52, 922.

¹⁰⁹ Department for Work and Pensions Consultation on clarifying and strengthening trustees’ investment duties (June 2018) [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/716949/consultation-clarifying-and-strengthening-trustees-investment-duties.pdf] [last visited on 30 October 2018].

investor stewardship and engagement.¹¹⁰ These misconceptions are particularly worrying because they may be perpetuated over time within pension fund investment practices through embedded organisational discourse, as Tilba and Wilson suggest.¹¹¹ Furthermore, if the pension fund does not invest in the employer company, there is presumably no duty for any stewardship under the Code, as no shares are held.

The findings of this paper also have implications for our understanding of accountability relationships between pension funds, pension fund trustees and their investee corporations. This study finds that the lines of accountability between pension fund trustees and their investee companies are loose and confused. This is something Hendry, et. al. have observed, but did not explain.¹¹² As an ambiguous and flexible concept ‘fiduciary duty’ seems to give trustees a ‘curtain’ behind which to hide when stewardship is concerned. In theory, trustees and pension fund executives have the discretion to decide what ESG investments or stewardship activities are in the best interests of pension fund members. On the other hand, in practice there may always be

¹¹⁰ The Stewardship Code, above n 11; The Kay Review of UK Equity Markets and Long-Term Decision Making, available at: <http://www.bis.gov.uk/assets/biscore/business-law/docs/k/12-631-kayreview-of-equity-markets-interim-report.pdf> [last visited 15 April 2018].

¹¹¹ A. Tilba and J. Wilson, ‘Vocabularies of Motive and Temporal Perspectives: Examples of Pension Fund Engagement and Disengagement’ (2017) *British Journal of Management*, 11. The authors argue that pension fund engagement and disengagement may be an example of organisational enactment through co-production of organisational narratives, which is a systematic and self-reinforcing processes that can provide the dominant patterns of sense-making and reasoning which also can be persistent over time.

¹¹² Hendry, et. al, above n 48, 223.

an ‘alternative’ view or solutions to how the same duty can apply. Therefore, it is possible for trustees to choose the simplest solution, which is to do nothing and delegate engagement to the investment fund managers. This raises questions about the relevance of a stewardship perspective as applied to the specific case of pension funds. Jay Youngdahl calls this an ‘ethical disconnect’.¹¹³ Theoretically, we thus illuminate contemporary manifestations of the Kantian dilemma, namely, how to prevent a possible abuse of self-regulation without undermining self-regulation itself. As the relational paradigm in contract and trust law is increasingly being eclipsed by the reality of intermediary domination in defining investors’ nature of participation and as the funds’ corporate governance positions are determined by asset management funds, not their savers or their trustees, our findings of the interpretations of the pension fund trustee duties become even more significant for the current policy debates.

POLICY IMPLICATIONS

This paper highlights significant challenges of using ‘fiduciary duty’ as a tool of governance in light of the ongoing governmental reviews of instructional codes of best practice.¹¹⁴ The Stewardship Code and the subsequent 2012 Kay Review

¹¹³ J. Youngdahl (2014) ‘The fiduciary duty to protect: the forgotten duty in pension fund investment’. Law and Financial Markets Review, 8:3, p. 245.

¹¹⁴ FRC, (December, 2017) Proposed Revisions to the UK Corporate Governance Code, available at: <https://frc.org.uk/getattachment/f7366d6f-aa57-4134-a409-1362d220445b/;.aspx> [last visited 7 April 2018]. The Stewardship Code 2012 revision (2018) Financial Reporting Council [https://www.frc.org.uk/getattachment/f7366d6f-aa57-4134-a409-1362d220445b/;.aspx [last visited 7 April 2018]; Financial Conduct Authority (2018) Discussion Paper on a Duty of Care and potential alternative approaches <https://www.fca.org.uk/publication/discussion/dp-18-05.pdf> [last visited 7 April 2018].

highlighted the excessive focus on the short-termist investment strategies in UK equity markets, arguing that this is detrimental to sustainable value creation in British companies. The Kay Review sought to address this longstanding concern by encouraging investor stewardship and recommending that ‘all participants in the equity investment chain should observe fiduciary standards in their relationships with their clients and customers’¹¹⁵ Interestingly, and perhaps contradictorily, the findings of this study suggest that although stewardship has been put forward as a solution to investment short-termism and the lack of ownership by institutional investors, in reality a lot of trustees believe that their fiduciary duties are pulling pension funds away from the original interests of pension fund members towards considerations of investee company interests, which are perceived to be far removed from those of the pension fund beneficiaries. The findings of this paper suggest that using the concept of ‘fiduciary duty’ as envisaged by the Stewardship Code is problematic for pension funds for a number of reasons.

Firstly, the interpretation of ‘fiduciary’ standards varies significantly from fund to fund. The legal concept of fiduciary duty to act in the best interests of pension fund beneficiaries gives trustees flexibility in dealing with uncertainty and problems in the investment and management of pension fund assets. Such flexibility has resulted in marked differences in pension fund trustee understanding of what it actually means to act in the ‘best interests’. The implementation of the concept of fiduciary duties in practice seems far removed from the notions of corporate stewardship and engagement because the majority of trustees interpret their fiduciary responsibilities in a very narrow

¹¹⁵ Kay Review, above n 91, 12, Principal 5.

way as ensuring that pensions are paid by producing the best possible monetary returns on investment. Thus, our evidence suggests that there is a disconnect between the legal definition of fiduciary duties and the application of such duties in practice, where some pension fund trustees believe that the law precludes them from ‘unjustifiably’ spending pension fund resources on engagement and considering non-financial factors.

Secondly, although the general law concept of fiduciary duty is sufficiently flexible to allow ESG concerns to be taken into account,¹¹⁶ it does seem to conflict with the regulatory framework within which pension fund trustees operate. Namely, as a principle of general law a person acting as a trustee has to act in accordance with the terms of the trust¹¹⁷. This would normally be set out by the settlor (the creator of the trust) in the trust deed. Stewardship as a relatively new concept has not been explicitly included in the terms of the pension fund trusts. Similarly, Stewardship is not looking to create legal obligations on the trustee but to set out ethical guidelines for trustees who

¹¹⁶ See Section 5.76 of The Law Commission Final Report on Fiduciary Duties of Investment Intermediaries (2014) [https://s3-eu-west-2.amazonaws.com/lawcom-prod-storage-11jsxou24uy7q/uploads/2015/03/lc350_fiduciary_duties.pdf] (accessed 30 October 2018) and section 20 of the DWP Consultation on clarifying and strengthening trustees investment duties (July, 2018) https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/716949/consultation-clarifying-and-strengthening-trustees-investment-duties.pdf (last visited 30 October 2018)].

¹¹⁷ See The Pensions Regulator summary of the Duties and powers with the key duty is to act in line with the trust deed and rules [<http://www.thepensionsregulator.gov.uk/trustees/role-trustee.aspx>] [last visited 30 October 2018].

would have to comply with the terms of the trust under which they act. Some trusts¹¹⁸ will also have statutory overlays such as the Trustee Act 2000 or for charities (the Charities Act) and pensions (the Pensions Act). For example, see the Charity Commission's guidance¹¹⁹ or the guidance from a local authority in relation to its pension scheme¹²⁰. From these examples, it is clear that the Stewardship Code is guidance and not a legal obligation. A trustee who had reservations about a particular investment decision (remembering that trustees may be personally liable for breaching the law in respect of investment decisions) can apply to the courts for a direction as to whether it is proper to make that investment or indeed a decision can be challenged in some cases by other trustees or the beneficiaries of the trust.

Thirdly, there is also a matter of delegation. Under the duty of care¹²¹ and PERG 10.3 trustees delegate the day to day management of the pension scheme investments to avoid the need for authorisation under the FSMA¹²². In this regard, in order to be an effective delegation, it can be argued (and our interviewees did argue this) that if

¹¹⁸ Trustees under English law trusts are not a separate legal person. Scottish law is arguably different on this point.

¹¹⁹ Charity Commission for England and Wales (2018) Guidance The essential trustee, what you need to know, what you need to do.

https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/734288/CC3_may18.pdf [last visited 30 October, 2018].

¹²⁰ Lancashire Council trustee guidance on Fiduciary Duties relating to ethical considerations <http://council.lancashire.gov.uk/documents/s20901/Fiduciary%20duties%20and%20ethical%20investment%20Appendix%20A.pdf> [last visited 30 October 2018].

¹²¹ See our earlier discussion section on the Duty of Care

¹²² See PERG 10.3 for occupational pension schemes (OPS) <https://www.handbook.fca.org.uk/handbook/PERG/10/3.html> [last visited 30 October 2018].

trustees undertook any active monitoring of investee companies, this might bring them within the scope of regulation and potential liability which they clearly did not want to be (see Q8 under PERG 10.3, which outlines the type of decision a pension fund trustee can make without being authorised by the FSMA)¹²³. The Pension Regulator also provides a summary of trustees' duties and powers with regards to delegation¹²⁴.

¹²³ PERG 10.3 Pension Scheme Trustees <https://www.handbook.fca.org.uk/handbook/PERG/10/3.html> [last visited 30 October 2018]. For example, trustees '...can make: strategic decisions, such as decisions: about the adoption or revision of a statement of investment principles as required by relevant pensions legislation; or about the formulation of a general asset allocation policy; or about prescribing the method and frequency for rebalancing asset classes, and the permitted ranges of divergence, following the setting of the general asset allocation policy; or about the proportion of the assets that should constitute investments of particular kinds; or affecting the balance between income and growth; or about the appointment of fund managers; or as to which pooled investment products to make available for members to choose from under a money purchase scheme'

¹²⁴ According to The Pensions Regulator; 'Where the trust deed and rules allow you to delegate a power and you do so, you remain accountable for the actions taken. However, where you have delegated responsibility for investment decisions, your liabilities are generally more restricted. This is as long as you can show that you and the other trustees took appropriate steps to satisfy yourselves of the matters set out above'. <http://www.thepensionsregulator.gov.uk/trustees/role-trustee.aspx> [last visited 30 October 2018].

It is important to clarify that the law does not oblige ‘best interests’ to be interpreted solely in terms of *financial* best interests¹²⁵. A more recent FCA’s discussion paper on fiduciary duties provides further clarifications on this matter¹²⁶.

¹²⁵ See Fair Pensions, (2011), The Enlightened Shareholder - Clarifying Investors’ Fiduciary Duties [available at: http://shareaction.org/sites/default/files/uploaded_files/policy/EnlightenedFiduciaryReport.pdf], p. 18; See also Section 5.76 of The Law Commission Final Report on Fiduciary Duties of Investment Intermediaries (2014) [https://s3-eu-west-2.amazonaws.com/lawcom-prod-storage-11jsxou24uy7q/uploads/2015/03/lc350_fiduciary_duties.pdf]) [last visited 30 October 2018] and section 20 of the DWP Consultation on clarifying and strengthening trustees investment duties (July, 2018) https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/716949/consultation-clarifying-and-strengthening-trustees-investment-duties.pdf [last visited 30 October 2018]. For example: “20. Our proposed Regulations are intended to reassure trustees that they can (and indeed should):

- take account of financially material risks, whether these stem from investee firms’ traditional financial reporting, or from broader risks covered in nonfinancial reporting or elsewhere;
- fulfill the responsibilities associated with holding the investments in members’ best interests – whether directly or by others on their behalf – not just through voting, but the full range of stewardship activities, such as monitoring, engagement and sponsoring or co-sponsoring shareholder resolutions;
- have an agreed approach on the extent, if at all, to which they will take account of members’ concerns, not only about financially material risks such as ESG, including climate change, but the scheme’s investment strategy as a whole; and
- use the SIP as a real, effective and regularly-reviewed guide to investment strategy and not as a generic ‘box-ticking’ document.”

¹²⁶ See FCA Discussion Paper 18/5, annex 1 for a summary of their understanding of the position (<https://www.fca.org.uk/publication/discussion/dp-18-05.pdf>) FCA distinguishes between the legal

Notwithstanding these ongoing clarifications, the current trustee perception seems to be that the common law fiduciary duties override any duty that trustees may have to comply with the Stewardship Code requirements. If that is the case, extending pension fund trustees' responsibilities to monitoring how their fund managers carry out their investment duties and how investee companies comply with proper standards of corporate behaviour can presumably only be pursued if the Stewardship Code is recognised by the FCA and the Pensions Regulator. The FCA has reopened the "Duty of Care" and fiduciary issue with a discussion paper.¹²⁷

It becomes apparent that from a legal standpoint, the question of Stewardship and its compatibility with 'fiduciary duty' should be a question of the legal status of the Stewardship Code itself – currently it isn't law, it isn't regulation, it isn't judge-made law, therefore it doesn't get "recognised" and therefore binding. Under FSMA there is provision for the recognition of industry codes but as yet the FCA has not recognised any.¹²⁸ Fiduciary duty and the associated 'duty of care' are implicit in the existing

model of "duty of care" and a regulatory one based on the FCA Principles for Business and, presumably, on the SMCR for individuals. There are also a number of FCA rules that contain an obligation on firms to take 'reasonable care' for certain activities.

¹²⁷ FCA Discussion paper on the Duty of Care and Potential Alternative approaches (2018) [<https://www.fca.org.uk/publications/discussion-papers/dp18-5-duty-care-and-potential-alternative-approaches>] [last visited 30 October 2018].

¹²⁸ <https://www.fca.org.uk/about/recognised-industry-codes>) FCA has issued a policy statement in July of this year setting out their "approach" <https://www.fca.org.uk/publications/policy-statements/ps18-18-industry-codes-conduct-discussion-paper-fca-principle-5> and they have set out the process <https://www.fca.org.uk/about/recognised-industry-codes-criteria-process> for getting recognition of such codes, but no codes have been recognised.

regulations, but do not seem to be monitored or implemented by the FCA. What is required here is much more clarity around the existing FCA rules and when the FCA will act if those rules are not followed. Also, clear explanation about the consequences of any action both for the consumer and the firm involved should be provided. For example, clear explanation of the circumstances in which action *will* (not ‘might’) be taken by the FCA. Furthermore, a removal of the FCA’s numerous get out clauses and words such as ‘may’ or ‘might’ from the regulatory framework when it comes to stewardship will be helpful. All in all, there is a need to send the right signals at Regulatory level. For the Stewardship Code to have more weight in terms of its applicability in practice, it needs to be recognised by the FCA.

CONCLUSIONS

This study offers novel empirical evidence, which suggests that the relationship between fiduciary duties and Stewardship is ambiguous. This supports the academic lack of faith in self-regulation and the ability of the Stewardship Code to have a transformative impact on corporate governance.¹²⁹ The fuzziness of the concept of fiduciary duty, in the context of pension funds, where it means different things to trustees; the legal obligations of trusteeship that are imposed on them in their capacity of managing pension funds and insurance savings as well as the lack of regulatory recognition of the Stewardship Code represent significant barriers to pension fund acting as stewards of their investee companies.

¹²⁹ Cheffins, (2010) above n 2; 1004; Arsalidou, above n 12, 415; Reisberg, above n 1, Tilba and Wilson, above n 9, 11.

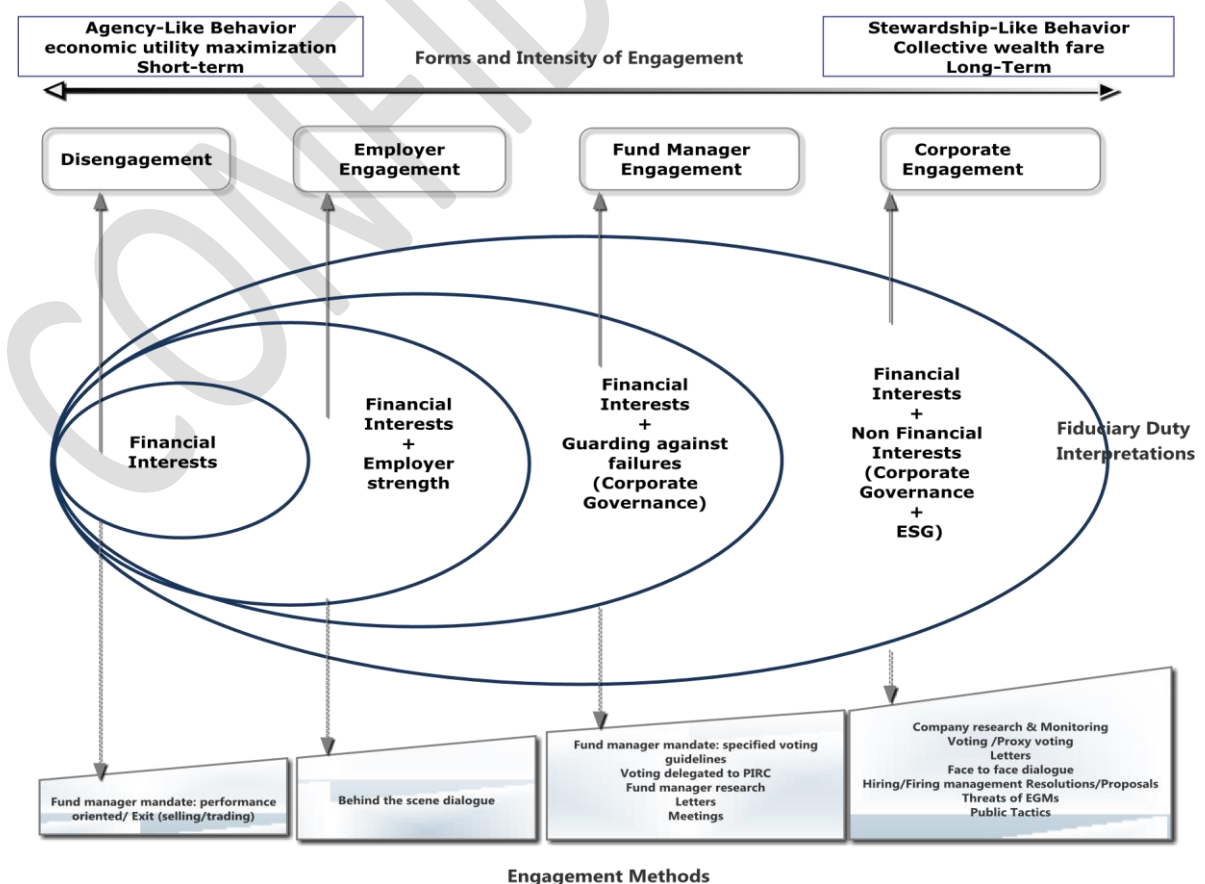
Although it is difficult to know whether the Stewardship Code will have or has had an effect on how trustees understand the content of their duty, or more generally how the Code may change understandings of duties over time, the findings of this paper offer further explanations as to why stewardship is proving elusive and raise questions about the effectiveness of the Stewardship Code and the nature of shareholder activism itself. The Pensions Regulator and the FCA should publish more guidance and more examples of bad practice, and showcase good practice when it comes to fiduciary duty and Stewardship.

The findings of this paper suggest that there is a need to educate trustees and clarify in law that broader considerations than simply financial may fall within the scope of fiduciary duties. An important first step towards this goal has been taken by the Law Commission in its Final Report on Fiduciary Duties of Investment Intermediaries. Furthermore, there is a need to design appropriate monitoring for the implementation of these mandates. The current investment mandates are ‘off the shelf’ solutions that investment consultants offer to trustees. These investment mandates are developed based on the economies of scale, which may not necessarily reflect the individual needs of a pension fund. In order for the mandate to deliver what is actually required for that particular pension fund, the trustees need to be absolutely sure that this mandate is able to deliver. We then need to decide how we define ‘value’ and ‘value creation’ and what does the delivery of this value proposition look like. There is also a need for a decompartmentalisation of ESG factors, which need to be integrated into the investment process throughout, rather than a separate ‘add on’ function in a separate department.

Another possible way forward for stewardship is pension fund engagement with their investment fund managers, rather than directly with their investee corporations.

The willingness and ability of some trustees to ‘stretch’ the meaning of fiduciary duty beyond maximizing returns over short-term by either engaging with companies directly or influencing their investment fund seems more realistic in terms of fulfilling the aspirations for shareowner stewardship envisaged by The Stewardship Code. To achieve this, there needs to be more clarity concerning the connection between fiduciary duty on the one hand and long term and responsible ownership by investors on the other. The Investor Forum, which has been created by industry practitioners in 2014 with a core objective of creating value can also serve as a rectifying mechanism in safeguarding the interests of asset owners, asset managers and corporations. Here, however, it should be noted that because of coordination and interests problems it has not showed willingness to do so.

Figure 1 The Spectrum of Engagement: Stewardship and Fiduciary Duties



CONFIDENTIAL